



**COLUMBIA
BUSINESS
SCHOOL**

CENTER ON JAPANESE ECONOMY AND BUSINESS

PROGRAM ON ALTERNATIVE INVESTMENTS

日本
經濟
經營
研究所

INVESTING IN HEDGE FUNDS AND PRIVATE EQUITY: VIEWPOINTS OF U.S. AND JAPANESE INSTITUTIONAL INVESTORS

Continuing its series examining Japanese institutional investments in alternative assets in comparative perspective, the Program on Alternative Investments at Columbia Business School's Center on Japanese Economy and Business organized a symposium titled "Investing in Hedge Funds and Private Equity: Viewpoints of U.S. and Japanese Institutional Investors." The event, held in midtown Manhattan on March 31, 2004, attracted a capacity audience of 125 people drawn mainly from the New York academic and practitioner communities.

The symposium was organized into two panel discussions followed by a keynote address.

The first panel focused on U.S. versus Japanese institutional investments in private equity. Hideya Sadanaga, Senior Vice President of Nippon Life Insurance Company, and Sheryl Schwartz, Managing Director of TIAA-CREF, made initial presentations on their respective institutions' views on and participation in private equity investing. Kazuo Seki, CEO of AI Capital, and Narv Narvekar, CEO of the Columbia University Investment Management Company, then offered comments as representatives of a Japanese financial intermediary and a U.S. university endowment.

The second panel examined investments in hedge funds. Kazuki Nakamoto, Managing Director of Daido Life Insurance Company, and Lawrence Kochard, Managing Director of the Virginia Retirement System, discussed participation in hedge funds from the viewpoints of a Japanese life insurance company and a U.S. public pension fund. Their presentations were followed by comments from Franklin Edwards, Professor of Finance at Columbia Business School, and Robert Discolo, Managing Director of AIG Global Investment Corporation.

David Russ, Treasurer of the University of California, concluded the symposium with a keynote address outlining his views on the overall rationale for alternative investments in an institutional portfolio together with the specific activities of his institution in this field.

This report covers the presentations and discussion of the panel on hedge funds. Although the private equity panel and the keynote address proved equally enlightening, the related symposium proceedings were unfortunately lost due to technical difficulties with the recording equipment.

The Program on Alternative Investments analyzes several major alternative investment asset classes—including hedge funds, private equity, and real estate—in Japan and elsewhere in East Asia. The Program meets its substantive goals through a combination of research projects, conferences, symposia, and seminar presentations under the direction of Dr. Mark Mason. For a schedule of upcoming seminars and other Program activities, consult the Program's website at <http://www.gsb.columbia.edu/japan/alternatives>. Dr. Mason can be contacted by e-mail at mm412@columbia.edu.

Lead Sponsors: Nomura Securities Co., Ltd.; Daido Life Insurance Company

INVESTING IN HEDGE FUNDS AND PRIVATE EQUITY:
VIEWPOINTS OF U.S. AND JAPANESE INSTITUTIONAL INVESTORS

PROGRAM ON ALTERNATIVE INVESTMENTS
Center on Japanese Economy and Business
Columbia Business School

The Lotos Club
Five East 66th Street, New York
Wednesday, March 31, 2004

FULL AGENDA

4:00 P.M.	WELCOME AND OPENING REMARKS Mark Mason Director, Program on Alternative Investments Center on Japanese Economy and Business Columbia Business School	5:25 P.M.	INVESTING IN HEDGE FUNDS Moderator Mark Mason Speakers Lawrence E. Kochard Managing Director of Equity and Hedge Fund Investments Virginia Retirement System Discussant Franklin Edwards Arthur F. Burns Professor of Free and Competitive Enterprise Columbia Business School Commentator Robert Discolo Head of Hedge Fund Group AIG Global Investment Corporation
4:05 P.M.	INVESTING IN PRIVATE EQUITY Moderator Hugh Patrick R.D. Calkins Professor of International Business Emeritus Director, Center on Japanese Economy and Business Columbia Business School Speakers Hideya Sadanaga Senior Vice President Nippon Life Insurance International Sheryl Schwartz Managing Director TIAA-CREF	6:25 P.M.	KEYNOTE ADDRESS Moderator Larry Glosten S. Sloan Colt Professor of Banking and International Finance Chair of Finance and Economics Division Columbia Business School Speaker David Russ Treasurer and Vice President for Investments University of California
	Discussant Narv Narvekar President, CEO, and CIO Columbia Investment Management Company Commentator Kazuo Seki President and CEO Alternative Investment Capital	6:55 P.M.	CLOSING REMARKS Hugh Patrick
5:05 P.M.	COFFEE BREAK	7:00 P.M.	COCKTAIL RECEPTION



"Investing in Private Equity" panelists from left to right: Narv Narvekar, Hideya Sadanaga, Sheryl Schwartz, Kazuo Seki, and Hugh Patrick



"Investing in Hedge Funds" panelists from left to right: Kazuki Nakamoto, Lawrence E. Kochard, Franklin Edwards, Robert Discolo, and Mark Mason

Investing in Hedge Funds

MARK MASON
Director, Program on Alternative Investments, Center on Japanese Economy and Business, Columbia Business School

Our second panel this afternoon examines U.S. and Japanese institutional investments in hedge funds. As we all know, the hedge fund industry is experiencing dramatic growth. There are now an estimated seven to eight thousand hedge funds worldwide, which together manage perhaps US\$800 billion or more in assets. Many U.S.-based institutions in addition to family offices and high-net-worth individuals have already made substantial commitments to the hedge fund industry, but only recently have their Japanese counterparts entered the field in any substantial way. Although it is likely that significant numbers of Japanese institutional investors will continue to enter into or increase their participation in the hedge fund industry, many among them have raised

serious concerns about such investments, ranging from transparency and liquidity to capacity, benchmarking, and performance. To consider the potential risks as well as rewards of hedge fund investing, we are joined this afternoon by a distinguished panel of speakers from leading institutions based in both Japan and the United States. I would like first to ask Dr. Lawrence Kochard, Managing Director of Equity and Hedge Fund Investments at the Virginia Retirement System, to share his thoughts with us. The Virginia Retirement System is a major U.S. public pension fund, of course, and Dr. Kochard has academic as well as practitioner credentials relating to the hedge fund industry.

LAWRENCE KOCHARD
Managing Director of Equity and Hedge Fund Investments, Virginia Retirement System

I span the real world and the academic world. I manage the equity group and the hedge fund program

for the Virginia Retirement System, which is a US\$40 billion defined benefit pension fund in Virginia for public employees and teachers. Virginia got involved fairly early with alternatives, investing in private equity in the late 1980s. This has paid off nicely, given their entry point. Even though we have just started our stand-alone hedge fund program, we in fact have been investing with equity market neutral managers and distressed managers within our public equity and private equity programs, so we have also had a lot of experience with hedge fund-type managers. We have a board, an investment committee, and a staff that is interested in looking at all alternatives.

Let me start this talk by discussing the University of Virginia, where I teach part time. I teach an investments course every spring. Several years ago, the University sponsored a symposium not that different than this, on hedge funds. Virginia is fortunate enough to have a number of

hedge fund managers who are stars, which includes a lot of Tiger cubs. The first panel consisted of Julian Robertson, John Griffin, Michael Bills, Paul Tudor Jones, and Lee Ainsley. It was a tremendous panel, talking about hedge funds and investing. They discussed a number of interesting issues and are clearly very talented investors. The day concluded with a presentation from a 24-year-old University of Virginia alumnus who had worked at one of the larger funds and who was starting his own hedge fund. Even though this fledgling investment manager had no track record and struggled to articulate an investment strategy and process, he had already raised \$25 million of assets. This story relates to a comment made earlier today, which articulated a healthy skepticism about all alternatives. One of the panelists, Narv from Columbia, was talking about what he expects from both private equity and hedge funds in the way of future returns. I think he expresses a very legitimate concern. This is largely due to the amount of money going into this market. I like to do this when I teach: I read from the *Wall Street Journal* or another investment publication. This is the most recent issue of *P&I*—article one: “Pension Funds Investment Causes Crunch in Capacity”; article two: “Luring Marketers Is Proving Tough to Managers.” So, they are trying to hire marketing people—that is not a good sign from my standpoint, especially when there is a capacity crunch. There is just a lot of money going into this asset class. VRS, as a mid- to large-size public fund, has US\$40 billion in total assets. Calpers has well in excess of three times this amount of money to invest. We are trying to invest a lot of money. Investments in

hedge funds could never be a sizable percentage of our assets. However, there are a lot pensions that are looking to dip their toes in the water, so to speak, putting money in hedge funds. The concern I have, and one of the reasons all plan sponsors are looking at these alternatives, is because we are all somewhat pessimistic about the markets. A prior speaker asked “Where is the alpha? Where is the beta?” Where are returns going to come from to fund the pension liabilities that we, and every other pension around the world, has. Everyone is looking for that magical alternative high-return investment. The fact that so many people are trying to generate extra alpha to compensate for the lack of market returns is what will necessarily lead to greater market efficiency and hence lower alpha. This will put a cap on how much money we can practically invest in hedge funds. As my colleague from Columbia said, that does not mean we should not do it. There are still, in my mind, very talented investors out there who are in the hedge fund world. There are still talented investors in the private equity world and it should not stop us from doing that, but we should approach this with a healthy degree of skepticism. Of the half dozen reasons that I have given to my board, investment committee, and, therefore, the public, for why VRS is investing in hedge funds, I would say there are two I feel strongest about. The first, a performance incentive-based compensation structure attracts some of the best investment management talent in the industry to this business. Secondly, managers invest a majority of their own wealth in the funds, differentiating themselves from traditional long-only money managers.



Lawrence Kochard

The others you probably see in every other hedge fund presentation: the fact that hedge funds can generate returns that have low volatility, low correlation with other assets, and that they are able to do things that are nontraditional, capitalize on opportunities. These are all true, but there are two arguments that get me most excited about hedge funds. Without a doubt, the talent is gravitating away from the long-only world to the hedge fund world. I see this firsthand since I also run the public equity group where we invest US\$26 billion, with the majority of this money being managed externally. Why is this occurring? (A) Because they are making more money; (B) because it is more interesting; and (C) because it is less transparent, and they do not have to deal with the clients quite as much. It is just attracting the best and the brightest. It is also attracting the best and the brightest from Wall Street. Having worked at Goldman Sachs years ago, very few of my former colleagues are still with the firm. A lot of them have started hedge funds. Years ago, someone would work at Goldman Sachs ten years, maybe twenty years, and then go off and either start a hedge fund or private equity firm.

Without a doubt, the talent is gravitating away from the long-only world to the hedge fund world.

—Lawrence Kochard

Now, I have a former student who did two years in the analyst training program and left to trade for a large distressed firm. He is doing very well. The amount of time it takes to go from the banking world or the sales and trading world to the hedge fund world has been cut down substantially. This influx of the best and brightest into hedge funds gets me interested as an investor. However, it also attracts a lot of bad people because the pay is so high. Two years ago I was speaking at a conference that was not nearly of the quality of this conference. I was sitting at lunch during that conference and I was asking the gentleman on my right, “What do you do? Why are you here?” and he said, “Well, I just sold my broker-dealer down in West Palm Beach and I am trying to figure out my next business and I have heard these hedge funds are a great way to make money.” The business will continue to attract the best, but it is going to attract the worst, too. That really raises the bar in trying to determine who is good and who is not. The second reason I get excited about hedge funds compared to the long-only world is that the managers eat their own cooking. They are

investing alongside of me. The vast majority of hedge funds have most of their liquid net worth invested in the fund and to me, that is the ultimate risk control. That helps me get comfortable with some of the lack of position transparency that exists. In fact, if there is any kind of transparency I want, it is getting some kind of read on what is the percentage of their wealth that is invested in the fund. This is the thing that really distinguishes these types of investment managers from a lot of other investors. These are the reasons that people got interested in hedge funds—they are high return, lower risk relative to the public markets. It is a well-known fact that there is survivorship bias in the data, and there is also a reporting bias problem, where only good funds report to the databases. The returns are also artificially smoothed. This was shown in a study by Cliff Asness, who is a very good hedge fund manager. This smoothing produces artificially low volatility and correlations to other assets. Another thing to be aware of is that a manager can produce the appearance of good returns by going short volatility, just selling options. What have all the good return numbers done? The result has been a

rapid rise in hedge fund assets as we discussed before. One hedge fund expert believes the total capital invested in hedge funds will increase to two trillion dollars by the end of the decade. That is just a guess, but I do think that there is a broad trend to increase the allocation to hedge funds. Public funds still have a small allocation to hedge funds and express a lot of skepticism about these managers. It is still an open issue whether public funds will broadly embrace hedge funds. Fundamentally, public funds often conclude that if an asset class is not a meaningful percentage of assets, then it is not worth pursuing. I contend that if there is any source of alpha, it is worthwhile trying to do some of it. If you cannot find any alpha, then go passive. One of the biggest challenges for us is trying to keep and retain good staff to help manage alternatives, both hedge fund and private equity programs. I think that is going to be one of the natural constraints and limitations for public funds. I will discuss this and other hedge fund issues that are important to us as a public fund. These issues include performance, fees, transparency, benchmarking, and fund of funds.

I do not think Japanese pension funds possess sufficient expertise in-house to conduct hedge fund due diligence without the help of outside advisers.

—Kazuki Nakamoto



Kazuki Nakamoto

First, the fees are outrageously high. It is just like the private equity world. It is hard to justify them and it is hard to justify how much money is made by hedge fund managers. With that said, if they can generate good returns and you can be convinced you are going to participate (it is not just the managers participating), then it is worthwhile doing. But identifying those managers that truly have an edge, the term that Narv used before, is not an easy task. One of the books I made students read for my class this year is the book *Money Ball*. It has a lot of great analogies for investment business, one of which is value investing. The book also highlights the difficulty of spotting talent and also shows that talent is not always what it appears at first glance. Billy Bean, who is the main character in the book, winds up becoming the very successful manager of the Oakland Athletics. He was a very successful high school baseball player, was recruited by everyone, and was considered a “can’t miss.” I believe he was the second draft pick that year. However, once in professional baseball, he was a bust. He looked great on paper. He was tall, handsome, fast, could throw well, could hit well, but he was not a winner.

The same challenge exists for investors who are trying to evaluate and find talented investment managers, including hedge fund, private equity, and long-only managers. Evaluating talent is difficult. One traditional approach, looking at historical track records, turns out to be pretty worthless for predicting future returns from a manager. Unfortunately, there is no science that helps—you must look at a lot of other intangibles. It is a tough, messy process. Everyone obviously wants to be in the good funds, but it is not easy. There are a lot of academic studies that go both ways, whether or not it makes sense to invest in hedge funds. Like private equity, there is a wide deviation between top quartile and bottom quartile performers, and given the number of funds that are starting, it is going to be difficult picking the good managers, increasingly difficult. Some evidence exists that smaller funds are better, so if you are looking to expand a program, getting into a larger number of smaller funds may make sense.

In terms of transparency, we are comfortable with risk exposure transparency and, as I said, more organi-

zational transparency—what is going on underneath the hood, having access to the portfolio manager, getting to talk to them, really understanding what they are doing. We do not need position level transparency.

Benchmarking is another difficult subject; we settled on the last alternative, which is a beta-adjusted benchmark. In terms of fund of funds, the good news is that there is going to be a lot of business on the public fund side. Public funds will have a hard time staffing up and investing in hedge funds the right way without any help. I think there will be a lot of opportunities for fund of funds. The difficult thing for the plan sponsor is the higher fees associated with fund of funds. Will the returns be sufficient to overwhelm all of the fees, especially in light of the low alpha world I anticipate? Is that extra level of fees going to make it that much more difficult for us, the plan sponsor?

In summary, I still think there are good managers out there. It is worthwhile for us to invest in hedge funds even if right now we are only 3 percent of assets. If we can take it up to 5 percent of assets, it is meaningful

if we can generate alpha. Identifying good managers will become increasingly challenging. Leveraging fund of funds, consultants, and other resources is going to be important for us to do our job effectively. Finally, being able to retain staff to manage a hedge fund program will be an ongoing challenge.

MARK MASON

Thank you, Larry. Our next speaker is Mr. Kazuki Nakamoto, Managing Director of Daido Life Insurance. Mr. Nakamoto has kindly agreed to enlighten us on Japanese institutional views toward hedge fund investing. I should point out that Nakamoto-san was one of the pioneers—and is now one of the thought-leaders—in the Japanese institutional investor community when it comes to investing in private equity as well as hedge funds.

KAZUKI NAKAMOTO

Managing Director, Daido Life Insurance Company

Before going into our hedge fund investment program, I would like to spend a few minutes describing our firm. Daido is the fifth largest life insurance company in Japan in terms of premium income, with total assets

of 6 trillion yen, or approximately US\$55 billion under management. We offer mainly individual term life insurance products to small-to-medium-sized enterprises that need to insure against the loss of their key management personnel. Japanese life insurance companies have suffered from a negative spread environment due to the chronically low interest rates in Japan. However, the profitability of our main products is relatively high for our industry, and we also have conducted a strategic Asset Liability Management study for our investments since the early 1990s. As such, Daido is currently one of the most profitable of the top ten largest Japanese life insurance companies and has the Standard & Poor’s financial strength of A+, reflecting its strong financial position. On the first of April 2002, Daido became the first demutualized and listed life insurance company in Japan. Back in 1999, we formed a comprehensive alliance with Taiyo Life to form a group called T&D Life Group, and Taiyo was demutualized and listed last year. On the first of April 2004, a joint holding company will be established. The new company will be listed on the Tokyo Stock Exchange.

It was in 1998 when we started hedge fund investing. I have been responsible for asset allocation at Daido since 1990 and saw both the decline of the stock market as well as the fall in interest rates. Daido continues to invest mainly in yen fixed-income assets, with a relatively small allocation to equity assets in order to maintain stable profitability. However, under this prolonged severe investment environment, we had to face the negative spread issue. The financial condition of our firm

was still healthy at that time, thanks to other profit gains that offset poor investment performance. However, I considered various ways to maintain the same rate of return with lower risk, or even to gain higher return with lower risk, and concluded that hedge fund and private equity investment would do this for us.

From early 1997, we started to study hedge fund and private equity investing. The main questions we had at that time were first, what are the sources of excess returns, and secondly, whether or not these excess returns can be expected to continue going forward. After researching this for a year and a half, we were fully convinced of the benefits of having alternative assets within our investment portfolio, and in June of 1998, our subsidiary in New York, Daido International, started to invest in hedge funds. With little manager selection capabilities in-house, we retained a sub-adviser for the program. One year later, our private equity program was also initiated.

The goal of our hedge fund investing program is to gain absolute return, which has a low correlation with traditional asset classes like equity and fixed income. Another alternative asset, private equity, generates a J-curve shape return, and negative performance is expected for the initial several years. To mitigate this J-curve effect, it is essential for us to have stable, absolute investment returns from hedge funds. Our target return for hedge fund investing is the Fed Funds Rate plus 4%.

We hired multiple gatekeepers to manage separate accounts specifically designed for Daido, and each gatekeeper was given a slightly different

investment mandate. None of them is allowed to invest in macro strategies, since our investment purpose is to gain a stable return. We also requested them not to have CTA strategies, because it is very hard for us to understand them. Currently, six gatekeepers manage separate accounts for our firm, and we are also in one commingled hedge fund of funds.

Under the current investment program, our private equity investments will be increased to 3.4% of the total assets, which will be US\$1.9 billion, and the eventual allocation to hedge funds will be 1.7%, or US\$950 million.

For the last five years, our return exceeded the Fed Funds Rate by 4.9% with a standard deviation of 3.39%. I am very pleased with this performance result because it achieved our initial goal of gaining a higher investment return, with only a moderate risk level.

Daido's hedge fund portfolio strategy is widely diversified. The return of our hedge fund portfolio last year alone was 10%, and this exceptionally good performance was achieved mainly as a result of the relatively large allocation to distressed strategies.

Now, I would like to touch upon the status of hedge fund investments by Japanese investors in general. Not much industry data exist that cover the whole investor universe in Japan. However, the Pension Fund Association did a survey of its 1,580 corporate pension fund members and found that 1.3% of the total assets is allocated to alternative investments. In value, the allocation is 583 billion yen or US\$5.4 billion in total. Out of this, more than 80% goes to hedge funds, which is a much higher number compared to Daido Life's allocation

among alternative assets. There seem to be two primary reasons for these phenomena. First, private equity itself is not well understood by Japanese in general, and the market itself is still at the developing stage. And, second, hedge funds generate profits within a relatively short period of time. Most pension sponsors in Japan have suffered from the decline of the Japanese stock market as well as low interest rates for the past ten-plus years, and therefore they do not like the J-curve, the negative early cash flow pattern associated with private equity investments.

A survey done by Goldman Sachs and Russell Investment Group shows the asset allocation to hedge funds by 49 leading pension fund sponsors in Japan. While the sample is very small, there is a clear trend of increasing hedge fund allocations, which is expected to continue.

The Pension Fund Association further analyzed the 1,580 corporate pension fund sponsors with an alternative allocation and found that larger sponsors tend to allocate more assets to alternative investments. In fact, if you look at corporate pension funds with total assets of 200 billion yen or more, which is US\$1.8 billion or more, approximately 93% of them either already have alternative programs or are currently considering adding one.

Let us examine some details of these hedge fund investments. These data include both hedge funds and private equity investments, but as I have already described, more than 80% of the alternative allocations goes to hedge funds. Roughly half of the money went to individual hedge funds. However, I would like to point out that these individual fund



Frank Edwards

investments were not necessarily made for the purpose of portfolio diversification. A majority of individual hedge fund investments by Japanese corporate pension funds was mainly in long/short strategy. We, at Daido, take a portfolio approach to hedge fund investments in order to achieve lower risk, and we, therefore, diversify the strategies of our underlying managers. Unlike our firm, most Japanese pension funds seem to have purchased individual hedge fund products from brokerage firms that claim they are market-neutral funds. This is my personal opinion, but I do not think Japanese pension funds possess sufficient expertise in-house to conduct hedge fund due diligence without the help of outside advisers. There are some sophisticated pension funds, but most invest in hedge funds without considering the strategic asset mix and risk-return profile of the overall portfolio. As such, they tend to concentrate on equity long/short strategies simply because these products are marketed by brokerage firms. Also, there seem to be many pension funds that believe long/short strategies have lower risk, since they are market-neutral. I believe that this could potentially be a serious issue

Hedge funds are largely unregulated, which leaves them free to exploit market inefficiencies that other, more restricted, fund managers cannot.

—Frank Edwards

for the future development of a healthy Japanese hedge fund investor base. We understand, from our experience, that many long/short strategies are biased toward long or short positions and therefore, careful fund selection is essential. Otherwise, they may become unexpectedly high risk investments.

In conclusion, as I have discussed, most hedge fund investing by Japanese pension funds has been in long/short strategies, unlike what U.S. investors have done. It is only relatively recently that Japanese investors, including pension funds, started investing in hedge funds and therefore, not much strategic diversification has been achieved to date. With the expected further penetration of hedge fund investments, Japanese investors will become aware of the importance of diversification. That being said, not many investors have the wherewithal in-house to do manager selection, so I believe commingled hedge funds of funds products will become increasingly popular. Thank you very much.

MARK MASON

Thank you, Mr. Nakamoto. I would next like to invite Professor Frank

Edwards, the Arthur F. Burns Professor of Free and Competitive Enterprise at Columbia Business School, to comment on the two presentations we have just heard. Among his other academic research interests, Professor Edwards has written widely on aspects of the hedge fund industry and brings to his work advanced training in law as well as finance.

FRANK EDWARDS

Arthur F. Burns Professor of Free and Competitive Enterprise, Columbia Business School

Thank you, Mark. Let me first begin by complimenting the speakers. I think they covered the ground pretty well, so I do not have much to say about what hedge funds are and what they do. Also, while the function of the discussant is to stir up some controversy, that may be difficult here because the speakers were careful not to overstate their positions. I will, nevertheless, try to provide a little controversy.

Most of the speakers say that, on the one hand, hedge funds make good returns—that they typically earn a positive risk-adjusted return (or alpha), but, on the other hand,

that there are lots of pitfalls for hedge fund investors. There are, for example, serious data problems, difficulties in selecting fund managers, and in monitoring the performance of hedge funds and in deciding when to fire poorly performing managers. Also, there is the blow-up factor: there are nonlinear hedge fund strategies that may look pretty good for a short time and then blow up with large losses. But, overall, the speakers conclude that investors should invest in hedge funds.

That conclusion raises an important conceptual issue, which none of the speakers address. Why are hedge funds able to earn positive alphas? After all, most fund managers, like mutual fund managers, typically are unable to earn positive alphas. Why can hedge funds do it? One answer is that there exist market inefficiencies that hedge funds can exploit. But why can hedge funds, but not other fund managers, exploit those inefficiencies? To complete this “inefficiency” argument, therefore, you need two things: market inefficiencies and a reason why hedge funds are able to exploit those inefficiencies while most other fund managers cannot.

Hedge funds are a talent pool, not an asset class, and talent is not scalable.

—Robert Discolo



Robert Discolo

But why do market inefficiencies exist at all? A possible explanation is that regulatory restrictions imposed on other institutional investors (like pension funds and mutual funds) and other fund managers prevent them from arbitraging away market inefficiencies, providing unregulated hedge funds with an opportunity to exploit such inefficiencies. An example may be legal restrictions on major institutional investors that prevent them from engaging in short selling as part of an investment strategy. A common characteristic of most hedge fund strategies is that they involve short selling to some degree. Another possibility is that the structure of hedge funds may allow them to capture a premium for illiquidity that other fund managers cannot capture because of regulations that restrict their holdings of illiquid investments. But these are just some possible explanations. What we really would like to have is some hard evidence of market inefficiencies and why they exist, which we do not have.

Assuming the existence of market inefficiencies, then, why should hedge fund managers be unique in being able to exploit these inefficiencies? There are two possible explanations.

First, hedge funds are largely unregulated, which leaves them free to exploit market inefficiencies that other, more restricted, fund managers cannot. Second, hedge fund managers may just be smarter—or more skilled at exploiting these inefficiencies. But why should this be true? The answer may be that they are just paid much better than other fund managers, and, as a consequence, the most skilled fund managers naturally gravitate to the hedge fund industry. In particular, hedge fund managers are typically paid a percentage of the fund's earnings (often 10% to 20%), which can mean large earnings for fund managers and a better alignment of their interest with those of hedge fund investors. Of course, a potential drawback to this compensation structure is that hedge fund managers may have an incentive to take more risk than investors wish to take in order to increase their own income. But notwithstanding this caveat, the argument is that, because they are unregulated, hedge fund managers are better able to exploit market inefficiencies and have a greater incentive to seek out profitable opportunities. I would have liked to hear the panelists' views on these issues.

In addition, I would have liked to hear the panelists discuss two other issues. First, do they think that there are market inefficiencies in Japan, and, if so, what are these inefficiencies? Are the inefficiencies different or greater in Japan than in the United States? Do hedge funds pursue different investment strategies in Japan than in the United States? Second, following up on the panelists' discussion of investor pitfalls, what kind of characteristics should we look for in a hedge fund manager? Alternatively, why should a pension fund manager (or anyone else) have the skills necessary to be able to select a good hedge fund manager? What are the skills that a pension fund manager needs to have to be able to do this successfully on a consistent basis? And why should we expect pension funds to hire managers who have the requisite skills? Pension fund managers are not typically paid in a way that aligns their incentives with those of their beneficiaries. It is a bit puzzling to me, therefore, why we should expect pension funds to be able to implement a successful hedge fund investment program.

Finally, I would have liked the panelists to address what I call the

“blow-up” problem. In particular, some hedge fund strategies yield what are often called nonlinear pay-offs, which basically means that you may get pretty good looking returns for two or three years or even longer, but then suddenly you get a huge loss. This has happened to many hedge funds and even to some of the most prominent hedge funds, like Long Term Capital Management. What is the appropriate strategy for managing this risk? And are you comfortable with being exposed to this risk?

I appreciate the opportunity to be here today and to be able to present my views. Thank you.

MARK MASON

Our last panel speaker is Robert Discolo, head of hedge fund investing at AIG Global Investment Corporation.

ROBERT DISCOLO

Head of Hedge Fund Group, AIG Global Investment Corporation

I come from a different viewpoint. I agree—there are inefficiencies out there. The problem is finding the guys who can exploit the inefficiencies. That is the challenge in hedge funds. One thing we did not hit

upon is: why are they so popular now? I have been doing this for fifteen years. I am commiserating with one of my colleagues from years and years ago. It has been a tough business for a long time. Somebody mentioned to me the other day, “Bob, you’ve been great. Returns are optimum, clients coming in, you are an overnight success.” I said, “Yeah, it took me 15 years to be an overnight success!” Why so popular now?

AIG’s philosophy is that hedge funds are a talent pool, not an asset class, and talent is not scaleable. We have been investing in hedge funds for over 20 years and the hardest single thing to do is to find talent. And lately with the explosion of hedge funds it is like trying to find a needle in a haystack, and the needles are getting smaller and the haystacks are getting larger.

We do believe that asset allocation is important but not as important as in traditional assets (where it accounts for over 90% of returns). Our theory is that alpha is 1/3 asset allocation and 2/3 manager selection. At AIG we look at over 500 funds a year and invest in maybe 5 or 10 with the process taking as long as a year. Our belief is that you have to study the manager, do detailed background and reference checks, extensive interviewing (including everyone in the firm, even secretaries), and finally do live trade examples with multiple visits. It is an art and a science. But the most important attribute of the manager should be integrity. At AIG we have a corporate culture of high integrity and expect the same from our managers, and we will never do anything to besmirch the AIG name as that is our most important asset.

This recipe has led us to successful hedge fund investing for over 20 years.

My big concern is that too much money is flowing into the business, and there is a shortage of quality managers. A lot of “dumb” money is being thrown at less than stellar managers giving hedge funds a bad name. I fully believe that hedge funds will be part of everyone’s portfolio in the future, but we have to be careful as to what we define as hedge funds. There are very few “true” hedge funds out there, and many people are paying high fees for beta, which anyone can get for 10 basis points from Vanguard.



Top: Larry Glosten introduces the keynote speaker. Bottom: David Russ, keynote speaker.

オルタナティブ・インベストメント(代替投資)シンポジウム
ヘッジファンドとプライベートエクイティ: 日米の機関投資家の視点から

2004 年 3 月 31 日、コロンビア大学日本経済経営研究所は、ニューヨーク、マンハッタンの中城に位置するロータス・クラブにて機関投資家のオルタナティブ投資に関するシンポジウムを開催しました。シンポジウムは、プライベートエクイティ投資、ヘッジファンド投資、キーノート・スピーチの 3 部構成でしたが、当日の録音器具のトラブルにより、誠に残念ながら第 2 部以外の議事録が残されておりません。心よりお詫びを申し上げます。

以下はヘッジファンド投資パネルの抄訳です。

オルタナティブ・インベストメント・プログラム ディレクター **マーク・メイソン博士**

すでに積極的なヘッジファンド投資が行われている米国に比べ、日本ではその動きが最近始まったばかりで、多くの機関では未だ透明性・流動性などの点で憂慮している。本日は 4 人のパネリストをお迎えして日米のヘッジファンド投資について考えてみたい。

バージニア州職員退職年金基金 **ローレンス・コシャード博士**

昨今ヘッジファンド投資への注目度が高まり多額の資金が注ぎ込まれているが、いくつかの懸念点も残されている。ヘッジファンドの世界には有能なマネージャーが流入している一方でそうでない者も多々おり、それを見分けられるかどうかこれから益々重要になってくるであろう。またヘッジファンド投資のハイリターン、ローリスクを示すデータにはかなりのバイアスがかかっているため注意しなければならない。私たちパブリックファンドとしてはヘッジファンドの手数料の高さに対するマネージャーのパフォーマンスの妥当性、透明性の低さ、ベンチマーキング手法、ファンドオフファンズなど外部リソースの有効活用について考えていかなければならない。

大同生命常務取締役 **中本和樹**

日本厚生年金基金連合会の調査によると 1580 の企業年金基金のうち 1.3% の資産がオルタナティブ投資に当てられ、ヘッジファンド投資はそのうち 80% とかなり高い。さらに大規模のスポンサーほどオルタナティブ投資への配分が高くなっている。日本ではヘッジファンド投資が最近始まったばかりであるためほとんどの年金基金は戦略的投資分散をせずロング・ショート戦略に集中しがちである。これはこの先深刻な問題になりかねない。また多くの投資機関はマネージャーセクションができるだけの資力を組織内に備えていないため、ヘッジファンドオブファンズへの合同運用投資が益々注目されることになるだろう。

コロンビア・ビジネススクール **フランクリン・エドワーズ教授**

これまで言及されていない論点として「なぜヘッジファンドはアルファ値を稼ぎ出せるのか」という問いがある。ヘッジファンドが市場の非効率性を有効利用できるからというのが一つだが、それではなぜ他のファンドには不可能なそれがヘッジファンドにだけ可能なのか。ヘッジファンド業界の規制の緩さ、高報酬なヘッジファンドへの優秀なマネージャーの流動化などの理由を挙げることできるが、これに対してパネリストの意見はどうか。加えて、日本に市場の非効率が存在するか、またヘッジファンドマネージャーに求めるべき素質について伺いたい。さらには私が"blow-up"問題と呼んでいる、数年好調だったヘッジファンドが突如大損失を出す問題と、そのリスク管理戦略についても興味がある。

AIG グローバル投資グループ **ロバート・ディスコロ**

市場に非効率は存在すると考える。その非効率性を有効利用できるマネージャーを確保できるかどうかヘッジファンドの問題だろう。アルファ値の三分の二はマネージャーセクションに懸かっているというのが我々の理論であり、よってマネージャー選びには念入りの検討が必要だが、特に欠かせない素質は誠実さである。ヘッジファンドが注目され多額の資金が注ぎ込まれている一方で、優秀な人材の不足により無駄になっている資金も多い。真のヘッジファンドと呼べるものはまだほとんどないのが現状である。

EDITOR

Dr. Yoko Mochizuki
Program Officer
Center on Japanese Economy
and Business

ASSOCIATE EDITOR

Emi Nakano
Program Consultant
Center on Japanese Economy
and Business

PHOTOGRAPHY

Joseph Piniero

LEAD SPONSORS

NOMURA

DAIDO DAIDO LIFE

**CENTER ON JAPANESE ECONOMY
AND BUSINESS**

Columbia Business School
321 Uris Hall
3022 Broadway
New York, NY 10027
Phone: 212-854-3976
Fax: 212-678-6958
E-mail: cjeb@columbia.edu
<http://www.gsb.columbia.edu/japan>